among non-competing distributors and are almost certainly not anti-competitive.

For these reasons, we conclude that the Commission should not prohibit, or severely limit, the ability of cable program services to charge different prices to different distributors. Although a showing that such differences may result in harm to consumers in particular instances is not impossible, evidence of such anti-competitive harm should be required before the Commission constrains price differences in any particular situation.

IV. EXCLUSIVITY

Exclusivity agreements are hardly unusual. Purchasers of rights to intellectual property generally, and specifically purchasers of rights for what broadly might be described as visual entertainment -- video programs, movies, sports events shown on television -- often purchase exclusive rights. Broadcast networks acquire exclusive distribution rights for the programming they distribute.[21] Affiliation agreements between broadcast networks and their affiliated stations typically convey exclusivity rights. When conventional broadcast stations acquire distribution rights directly in the syndication market, they typically purchase a degree of exclusivity.

Program services distributed by cable and other multichannel distributors also sometimes sell distribution rights that provide

[21] See Besen _et al._ (1984, pp. 121-124).

varying degrees of exclusivity. It should be recognized, however, both that carriage agreements between program services and cable operators do not always include exclusivity and that, when they do, the extent and nature of exclusivity vary. The agreement might give the cable operator exclusivity against all other video distributors in the area, or only exclusivity with respect to one or more alternative technologies. Exclusivity rights may be further limited by terms that obligate the cable operator to subdistribute the program service to other distributors in the area, and may either set limits on the terms of subdistribution agreements or only give subdistribution rights of first refusal that allow other distributors to seek direct agreements with the program service.

There should be no presumption that exclusivity, or the absence of exclusivity, is either always desirable for cable programming, or always sought and obtained by cable systems and other distributors or by cable program services. Economic analysis suggests that distribution by one or more than one multichannel distributor serving an area may be optimal for a program service.

This section examines the reasons why exclusive distribution arrangements might be selected for cable programming, and what effect such arrangements might be expected to have on consumers. We find that exclusive contracts can produce substantial efficiencies that benefit consumers. As a result, we conclude that the Commission should limit exclusives only in the particular circumstances where there is demonstrable harm to cable viewers.

A. Why Program Service May Not Sell Exclusives

The discussion first examines the factors that determine whether or not a program service will prefer to license only a single distributor. Exclusivity need not be driven by any desire to acquire or exercise increased market power in the distribution of programming. To make this clear, the analysis below rules out the possibility that exclusivity allows a distributor to exercise increased market power by assuming that the price charged subscribers by any particular distributor is unaffected by whether the program service also is carried by other distributors in the same area. Under this assumption, exclusivity cannot benefit program services either directly from the increased exercise of market power at the distribution level, or indirectly because distributors pass along some of their gains from increased market power to induce program services to offer exclusivity.[22]

We begin with a very simple case in which a program service is deciding whether to sell its service only to Distributor A, or to both Distributor A and B who operate in the same market.[23] With exclusive rights, carrying this service earns Distributor A $5000 in additional revenue net of additional costs incurred,[24] but

[22]This is not to say that exclusivity necessarily would allow increased exercise of market power by distributors; certainly in many cases exclusivity does not allow increased exercise of downstream market power.

[23]The examples and much of the analysis in this section adapt the analysis in Besen, et al. (1984, pp. 117-124).

[24]Additional costs could include costs of billing and of handling subscriber orders to sign up for the service.

before paying any license fee for the program service.

This increased revenue could stem from any combination of increased pay and basic subscription revenue and local advertising revenue, but here is a simpler story that generates this result: the program service is sold as a separate pay service at $1.10 to 5000 customers, and the distributor has billing costs of 10 cents per subscriber; there is no effect on basic subscribers or advertising revenue. If we assume that the next best alternative for Distributor A is to leave the channel dark (i.e., all other services that generate positive net revenue already are carried), then $5000 is the maximum amount Distributor A would be willing to pay in license fees rather than leave the channel dark.[25]

Now consider that Distributor B also sells video services in the same area. Carrying the program service would earn Distributor B additional revenues, again net of additional costs other than license fees, of $1500. If Distributor B's best alternative is to leave the channel dark, $1500 is the maximum amount B would pay in license fees. If B carries the service, however, the incremental net revenues earned by Distributor A fall to $4000, because some subscribers and viewers now take Distributor B's service. With both A and B distributing the service, A serves 4000 subscribers and B 1500 subscribers.

In this example, Distributor A would not get an exclusive. Total license fees are (at most) $5000 if Distributor A receives

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[25]Obviously this does not consider bargaining issues that are important in determining license fees in practice.

exclusivity, and Distributors A and B together would pay up to $5500 for rights without exclusivity. Said another way, the exclusive is worth at most $1000 to A, while Distributor B is willing to pay up to $1500 for non-exclusive distribution rights.

The general point is that while an exclusive often would be worth something to a cable system or other distributor, it may not be worth enough for the system to obtain the exclusive. Program services will sell exclusives only if they are compensated for the net revenue they forego from other distributors by selling the exclusive. When selling to several distributors increases the revenue the program service generates, it may not be profitable for any distributor to pay for an exclusive.

B. Why Exclusives Sometimes Are Profitable

Under some circumstances, however, it may be profitable for a program to sell only to a single distributor, even if more subscriber and/or advertising revenues would be generated with non-exclusive distribution.

1. Increased Transaction Costs

First, increases in revenue might be outweighed by cost increases from dealing with more than one distributor. To return to the example, assume that negotiating the contract with Distributor B and handling its license fee payments costs the program service $600 over and above the costs of dealing only with

Distributor A. Although Distributor B is still willing to pay $1500 for a non-exclusive contract, this is no longer enough to top Distributor A's bid for exclusivity. Distributor A is willing to pay $1000 for the exclusive. Distributor B will pay $1500 for distribution rights, but, as a result of selling to B, the program service also incurs $600 more in costs and so is left with a gain of only $900. The program service can earn $100 more by selling the exclusive than by selling Distributor B as well as to A.

2. The Alternative of Carrying Other Programming

A second reason exclusives may be profitable is that the alternative of carrying other programming may make distributors unwilling to pay to the program service the entire net revenue generated by carrying the service. If there are a limited number of channels to program, the best alternative to carrying one program service may be carrying another, rather than leaving the channel dark. Change the example and assume that the best alternative for both distributors was to carry another service (not necessarily the same for A and B), and that with this alternative each would earn $800 additional net revenue after paying all license fees. Given this new alternative, the most Distributor B will pay for the first program service is $700, the largest amount that can be paid and still leave net revenue after license fees of $800. By the same reasoning, the new alternative reduces the amounts Distributor A will pay to $3200 for a non-exclusive and to

$4200 for an exclusive.[26] Distributor A is still willing to pay an additional $1000 for exclusivity, and thus it can outbid the $700 Distributor B now is willing to pay for the program service. The more general point is that it may often be more profitable for a second distributor to differentiate itself by carrying programming distinguishable from that of its rivals.

3. Increased Costs of Distribution

Thus far we have treated the number of channels available to distributors as fixed. Multichannel video distributors, however, have some choice about their channel capacity, and there is an incremental cost of supplying additional channels. Once built, these may be sunk costs, but video distributors will not build additional channel capacity unless they expect to retain from programming those channels sufficient net revenue, above and beyond license fees and other variable costs, to cover the incremental cost of adding the channel. Otherwise, multichannel video distributors will not be in long run equilibrium.

In our example, if each distributor retains $800 in revenue to cover the incremental cost of a channel, Distributor A will be able to purchase an exclusive. Distributor B cannot pay more than $700 and cover the $800 incremental cost, while Distributor A will still

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[26]Each is the maximum amount Distributor A can pay and be left with $800 in net revenue.

pay $1000 additional for an exclusive.[27]

4. Signal Security and Collection Problems

In our earlier discussion of price differences, we showed how a video distributor's problems with signal security or financial stability could affect the price charged by a program service, or the willingness of a program service to sell to the distributor. In terms of the discussion here, either problem reduces the additional net revenue a program service expects to realize by selling to such a distributor rather than by granting exclusivity to a distributor without these problems. That makes exclusive distribution relatively more attractive.[28]

5. Increased Risk

Increased uncertainty experienced by each distributor also is likely to reduce the net revenue a program service can realize by selling to more than one distributor. Cable systems and other video distributors will have some expectation of the additional revenue they will earn by carrying a particular program service, but they still face considerable uncertainty. While uncertainty is always present, it is increased when the same program service is

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[27]Numerically this is exactly the same as the previous example; the only change is the reason why each distributor insists on retaining at least $800 in revenue.

[28]Indeed, in our previous example, because of security problems, granting a license to a second distributor reduced the program service's net revenues.

carried by a competing distributor. Increased substitutability between the offerings of the two distributors adds an additional source of variation in the value to a distributor of carrying a program service. If the distributors cannot be insulated from this increased risk, and if they are risk averse, the increased uncertainty will reduce the amount they are willing to pay for a license to a program service.[29]

To return to the original example, Distributor A's expectation is that it will receive net revenues of $4000 if the program service is also carried by Distributor B, while Distributor B's expected value for the net revenue from carrying the service is $1500. If these amounts are uncertain, each distributor risks a loss if it pays its entire expected net revenues in license fees. Risk averse distributors must be compensated for bearing increased risk; they will reduce the amount they are willing to pay by the amount of this risk premium, but that reduces the revenue the program service earns by selling to both distributors.

Distributor A also bears some risk if it purchases exclusive distribution rights, but this risk will be smaller with an exclusive, and therefore the risk premium is smaller. Risk is likely to reduce realized license fee revenue more when the program service does not grant an exclusive.

Of course if distributors could be insured against the increased risk, they would not reduce the amount they would pay.

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[29]We discuss below why, in practice, distributors probably cannot be insured against this risk, even though the gains of one distributor may largely offset the losses of the other.

The program service could insure the distributors against increased risk when the service is sold non-exclusively by varying the license fee according to the success of each licensee. The program service would appear able to provide this insurance at low cost; presumably the resulting variations in license fees paid by the two distributors would be negatively correlated, so the pooled risk borne by the program service would be relatively low.

In fact, including such an insurance policy in a contract would be difficult and costly. To know when and how much the insurance policy should "pay off," a way must be found to measure variations in the "value" of a service to a distributor due to lack of exclusivity. It is hard to imagine any method of measurement that would not be subject to manipulation by one or both parties and to endless disagreements and disputes.

First, changes in the value to a distributor of a service are not directly observable. Carrying a program service can affect distributor revenues by generating subscriber revenue directly from that service, by increasing subscriber revenue from other services (as when viewers subscribe to basic service in order to subscribe to a pay service), by increasing the value of a tier that includes the service, and by increasing advertising revenue received by distributors. At best, only changes in direct subscription revenue from a service, and perhaps changes in revenue from advertisements sold for that service, might be directly observable.

Second, as difficult as it would be to measure all variations in the value of a program service to a distributor, it would be even more difficult to measure variations due to a single cause: lack of exclusivity. Yet this would be necessary to insure program distributors against this source of risk alone.

This last problem could be avoided by insuring distributors against all sources of variation in the value of a program service (assuming that could be measured). Such broad insurance, however, would itself impose costs by destroying distributors' incentives to maximize the value of the program service through, for example, promoting the service, making efforts to sell local advertising, and so forth.

Although contracts may shift some risk from distributors to program services, they cannot eliminate the increased risk that distributors bear when they do not have exclusive rights to a program service without introducing offsetting costs and inefficiencies.[30]

6. Promotional Activity and Free Riding Problems

Even if no attempt is made to insure video distributors against risk, loss of exclusivity may reduce the revenue a program service earns because it reduces the incentives of distributors to act to maximize the value of the program service. Cable systems and other multichannel video distributors do more than passively distribute programming. Their efforts are important inputs in

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[30]The possibility of a conflict in vertical contracting between allocating risk and providing incentives is both general and well known; see for example Tirole (1988, Ch 4).

determining the total net revenue generated by the program services.[31]

The inputs provided by the distributor include a variety of kinds of promotion. Distributors publicize the launches of new program services on their systems, and provide continuing promotion of many of the services they carry. Promotions for pay services can be aimed both at getting more existing system subscribers to buy the pay service, and at attracting new subscribers to both the system and the service. Promotions for services carried on a basic tier received by all or nearly all system subscribers are more likely to be aimed primarily at those who do not currently subscribe to the system.

Distributors must also make efforts to sell local advertising time. The value of advertising on many cable networks is based not so much on the absolute size of the audience as on its composition; it is a way of reaching a targeted audience. Informing and demonstrating to potential advertisers that they can reach that specialized audience, however, often requires efforts by the distributor. This is particularly true for the many program services whose audiences are not routinely measured by the ratings services.

If a program service is carried by two distributors in the same area, some of the promotional efforts of each will benefit the other. Such "free riding" reduces the return a distributor earns

[31]Although the program service could engage in all of the promotion activities itself, it is often more efficient to have local distributors provide some of the promotion.

from its efforts and thus reduces its incentives to undertake them. As a result, individual distributors will fail to make some efforts whose total value exceeds their costs.

Of course, not all promotion activity will be subject to free riding, or equally subject to free riding. Promotion aimed by a distributor at its own subscribers -- promotion through bill inserts or cross-channel advertising -- is likely to be less subject to free riding by other distributors than promotion aimed at attracting those who do not now subscribe at all to their system. Furthermore, the value of promotion, and of different types of promotion, will vary from one program service to another, and so therefore will the potential for free riding problems.

To the extent that free riding is a problem when more than one distributor carries a program service, the net revenue that might otherwise be realized by adding a second or third distributor is reduced. As a result, in some cases, the service will prefer exclusive distribution.

Exclusivity is not the only tool to handle free riding, but the alternative solutions have limitations. The program services themselves could take over the organizing and financing of promotion, but it is doubtful that they could direct local promotion efforts as efficiently as distributors.

Program services could, and do, help finance promotion efforts. Having a program network provide financing does help overcome the disincentive to provide sufficient total resources. Because distributors still will have an incentive to free ride, however, those resources are likely to be used in ways that reduce their value. Absent exclusivity, each distributor still has an incentive to favor types of promotion for which there is less free riding, even though that results in a mix of promotion efforts with a smaller overall payoff (although not a smaller payoff to the individual distributor).[32] Program services can attempt to direct how distributors use promotional funds. The effectiveness of such efforts, however, will be limited both by the fact that distributors often have better information about what promotion is most effective and by the fact that such efforts impose additional costs of monitoring and enforcement on the program service. To the extent that free riding on promotion is a serious problem for a program service, the benefits of selling exclusive distribution rights are increased.

7. Why Have Exclusivity Clauses in Contracts?

In the cases described above, program services sell exclusivity rights because they find it more profitable to do so. Considered from the standpoint of distributors, a second distributor will not find it profitable to bid more for non-exclusive rights than a first distributor will bid for exclusivity. If selling to only a single distributor is the most profitable course, why, it may be asked, is it necessary to formally include

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[32]For example, distributors might overemphasize bill insert promotions, relative to promotions that attract new subscribers to the system. On the general point see Klein and Murphy (1988).

grants of exclusivity in contracts? To put it differently, is there any cost to banning exclusivity agreements?

The short answer is, yes, because the clause may be necessary to insure that the single distributor gets what it is paying for: exclusivity. Selling non-exclusive rights to two distributors might be less profitable for the program service than selling exclusive rights to one; in the absence of a contractual guarantee of exclusivity, however, a program service could be tempted to sell distribution rights to a second distributor. But, of course, knowing that this is possible, the first distributor will be willing to pay less for what is represented as the right to be the first and only distributor in that market of the program service. Distributors will pay more for contractually guaranteed exclusivity because there is less chance that they will fail to enjoy the benefits of exclusivity. If they cannot offer enforceable, contractual promises of exclusivity, program services will gain less by selling to a single distributor.

C. Conclusions: Exclusivity and Efficiency

There are a variety of reasons why program services may prefer exclusive distribution. As already pointed out, none of the reasons discussed here rely on a distributor being able to exercise increased market power because the exclusive rights it receives disadvantage some rival distributor serving the same geographic market. In addition, each of these reasons why the program service would prefer exclusivity also is a reason that exclusivity would contribute to greater efficiency.

Program services find it more profitable to use a single distributor within a market when that either reduces their costs or increases their revenues. Costs may be lower because using multiple distributors increases transaction costs, because the opportunity costs of obtaining channel capacity on multiple distributors is greater than for a single distributor, or because of the difficulty of insuring against the increased risk faced by multiple distributors. Each of these is a real cost to society that must be considered in determining efficient distribution patterns.

Using a single distributor also may avoid problems that reduce the revenue a program service can realize. Free riding may raise the costs of promotion, or distributors may be unable to prevent some viewers to receive a program service without paying or make it difficult for a service to collect for its programming. If the program service cannot use exclusivity to protect its revenues from these losses, the incentives to invest in programming are reduced and, in the limit, the viability of the service may be threatened.

Nonetheless, program services will not always want to sell exclusivity. The disadvantages described here of licensing multiple distributors in a market may be outweighed by the benefits of increased reach gained by the program service. If the additional net revenues from licensing more than one distributor are sufficiently great, program services will not grant exclusivity. The analysis here is completely consistent with the observed pattern that cable program services sometimes grant exclusive distribution rights and sometimes do not.

There is another implication of this analysis. The balance of benefits and costs from licensing multiple distributors may easily change over time. When the program service sees little prospect that an existing or potential second distributor offers much additional reach, the benefits of selling exclusive rights may outweigh the expected benefits of licensing a second distributor in a market, or of keeping open the contractual option of licensing a second distributor.

That balance can easily change when there is the prospect that licensing a second distributor in the market would substantially increase reach and profits. The fact that certain services sell exclusive distribution rights today does not mean a second distributor who offered the real prospect of additional viewers and revenues would be unable to purchase distribution rights. Observed exclusivity agreements may reflect the weakness of alternative distributors of programming and their inability to offer valuable additional services, rather than be a cause of that weakness.

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